

# SPOTLIGHT ON VALUE

*economic and market ideas and how they may benefit our investors*

BUILDING VALUE ASSOCIATES Ltd

Phone +44 208 287 9442  
E-mail enquiries@bvaltd.com

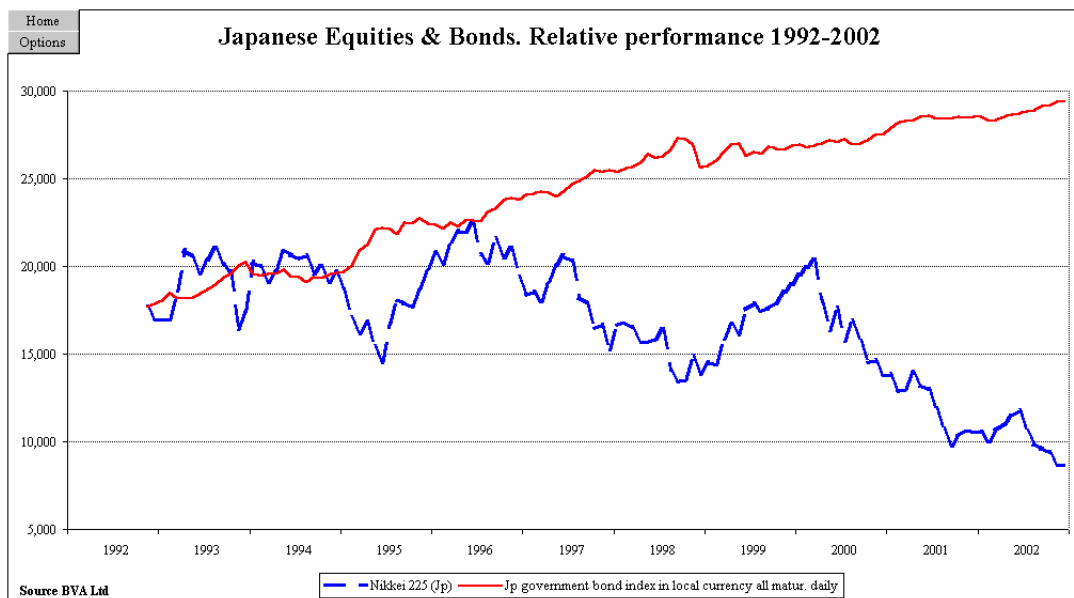
Equity Analysis  
Asset Management Advisory  
In-depth financial modelling  
and consulting

*10<sup>th</sup> December 2002*

## The problem with Japan's banks .....

**is that Moral Hazards abound.....**

Lowering interest rates to protect the financial sector in difficult times is likely to introduce moral hazards. Supplied with high liquidity and low interest rates, banks often do silly things with the money, unless constrained by the authorities to pay off earlier excesses. The crucial question is how to deal with the dead weight of the past. This is a serious problem in deflationary Japan, and could well become a problem for several other countries, including the US and Germany.



***Comment: Returns on bond investments have greatly exceeded those in equities over the last decade***

Additional liquidity can take the heat out of the situation, but it depends very much on how this is managed. The US handled the thrifts and loans crisis at the end of the 1980s very successfully, and the way they did so may contain important pointers for resolving the situation in Japan.

In the US there was a greater willingness to accept that the thrifts had made bad loans, and were effectively bankrupt. The thrifts, faced with the prospect of bankruptcy, were forced to accept being taken over en masse by a government-backed quango, Refcorp. The main losers in this situation were the shareholders, and in a sense the depositors, since many of the thrifts were mutually owned. The deposit insurance scheme meant that no one went penniless, and this was of advantage to the small savers. Larger savers did lose the bulk of their deposits. The thrift management also paid the consequences and were replaced.

Refcorp was able to arbitrage the fact that it could borrow much more cheaply than the thrifts could, and by taking on the loans and “re-packaging” the bad ones, were able to sterilise their effects on the broader economy. This process was helped by the fact that the very easy monetary stance adopted by the Fed was not passed on to the final consumer but used by financial institutions to rebuild their balance sheets. Thus, an easy monetary stance was not feeding a bubble elsewhere in the economy, while stricken financial institutions were supposedly putting their houses in order (too often a continuing bubble somewhere else in the economy is used by financial lenders as an opportunity to “use growth to rebuild profitability” but it rarely does so). While there were howls of anguish at the time, as with Enron and Worldcom, the thrift management teams had not endeared themselves to the American public, and there were few tears shed at their departure.

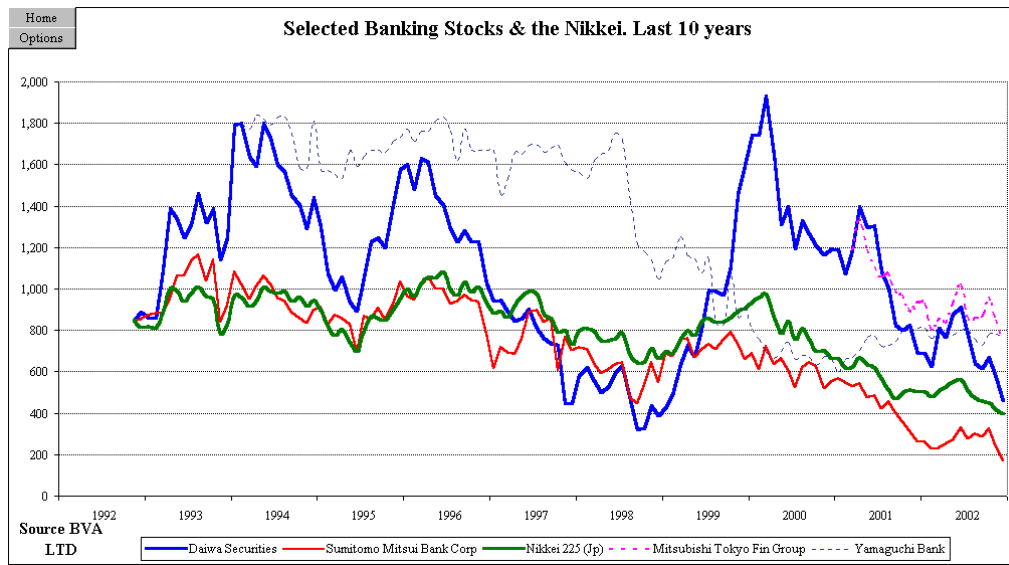
Shift the scene to Japan: It seems to us that there has not been the same willingness to “bite the bullet”. There are several reasons for this. One of them is that the penalties for insolvency may well be tougher in Japan than in the US. Japan is also in a deflationary mode, and hence the real cost of loans is still quite high – a classic problem in deflationary economies. The lack of inflation has not helped either, so that the real value of the debts has not been eroded, even though the asset base that secured them has. In addition, the division between banks and other businesses is nothing like so clear cut in Japan. There is evidence that government assistance to the Japanese banks has been frequently used to bail out dud borrowers, mostly in the construction industry, rather than tightening business practices and rebuilding their own balance sheets. One of the most important reasons is that the interest rate arbitrage option is not there, since the loans had low interest rates to start with.

## **Lessons from the US not applied to Japan**

The political and economic will to sort out Japan's banks and their bad loans has been lacking in Japan. The balance sheets of both banks and the government have got into a far worse state in Japan over the last twelve years compared with the corresponding stage of the Great Depression in America in the 1930s. Then, as nominal GDP fell in the first half of the 1930s, the ratio of America's net public debt to GDP nearly tripled, but as growth returned it flattened off. Despite less severe deflation, Japan's net public debt ratio is already far higher than America's was at its peak in the 1930s. It is still rising.

Japanese banks have long been treated as quasi-public-sector organizations; originally this was needed to get Japan's post-war business back on its feet but it has never stopped. Following a "long-standing social practice", as Noriko Hama, of Mitsubishi Research Institute puts it, the banks have continued lending at the behest of the government to companies they happened to like, always believing that the government would prevent the banks' own demise. In the early 1980s the collaborative relations between banks and businesses had turned to collusion and even conspiracy.

The situation is further complicated by the role of the "house bank" that sits at the heart of the "Keiretsu", or loose mutually supporting arrangement of companies in a variety of sectors. The house bank was clearly expected to bail out weaker members of the Keiretsu, even if this sometimes meant restricting new loans to the more dynamic parts of the group. As the performance of some of the groups has continued to languish, there are signs that the house bank role is gradually diminishing. Some Keiretsu members are now finding they can get better financial deals outside of the group than within it, thus threatening the continuation of the Keiretsu itself.



***Comment: Banking shares have tracked the Nikkei down, but do not appear to have performed significantly worse than the overall market***

When the yen appreciated after the Plaza agreement in 1985, and at the behest of the Americans, the Ministry of Finance opened the monetary throttle and lowered interest rates in part to dampen the yen's rise. A borrowing binge followed and much of the money went into property where prices were set not only by the market but also by indexes drawn up by bureaucrats to suit their own purposes. (The gardens of the Imperial Palace in central Tokyo were said to be theoretically worth as much as the entire state of California, or all of Canada.) Borrowing exploded, since land was used as collateral for almost all bank loans. And because Japanese banks and businesses have long had huge holdings in each other, when the speculative bubble burst it brought both of them crashing down together.

Even today the building budget is gigantic: construction-related spending has comfortably exceeded the budget of the American Defence Department in recent years, and about 10% of Japan's workforce, some 6m people, still derive their jobs from it, far more than in other rich countries. Unsupported, about half the industry might collapse, throwing millions more out of work. The Japanese government throughout the long period of stagnation of the 1990s has struggled to support both construction and banking which has slowed down the resolution to their problems.

By the late 1990s, the Japanese government tried to heal its ailing banks by pumping money into them. Big, weak banks also sought to fix themselves by merging with each other, but without the needed restructuring that might have put their businesses back on track. What they needed was to streamline their operations to become more efficient and

they failed to do so. Thus today the banks are still barely profitable, with bad debts of ¥150 trillion (\$1.3 trillion) and weak working capital.

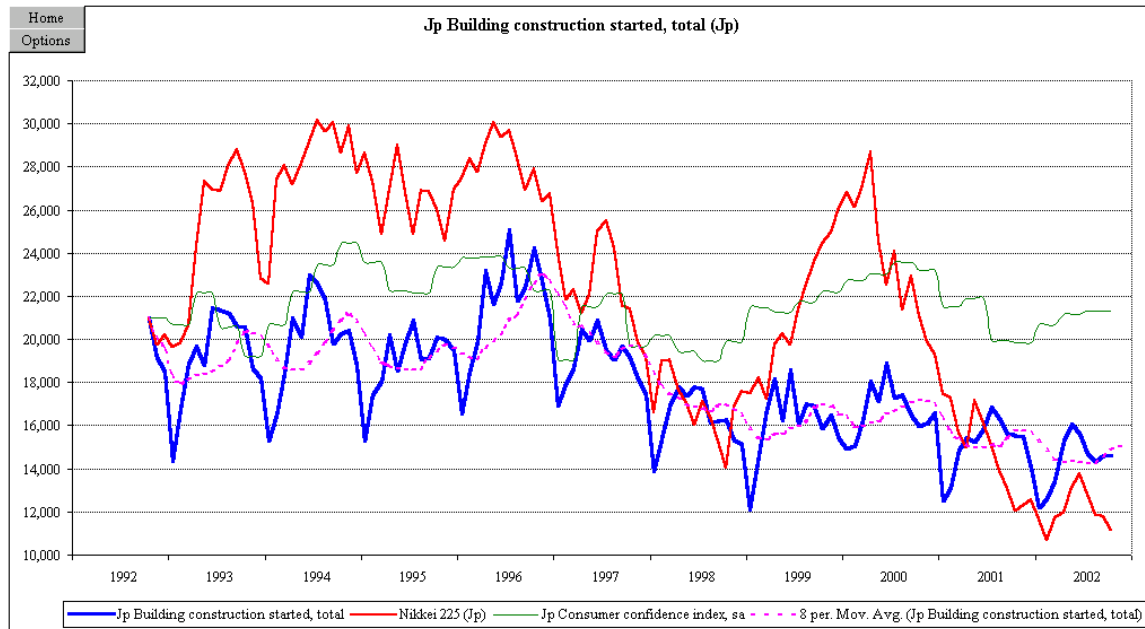
### **Excess Savings drives down yields and interest rates – encouraging more savings !**

The financial and banking system for so long has acted as though there was a shortfall of savings within the economy. In reality the Japanese are the most thrifty of people. Not only are they careful with money but they are the biggest exporters of capital in the world, much of their savings flowing to the US where there really is a shortfall of savings. The difficulty from a Japanese savers' point of view is that for many years the low returns on domestic investments were still higher than the returns on foreign investments, which were eroded in yen terms by the continued strength of the yen against other currencies.

This helped to keep more Japanese savings at home than was desirable. Because so much of Japanese savings remain in Japan, swelling the coffers of the banks and other important institutions it has been too easy for domestic institutions to go out and invest the money unwisely. The most trusted of these, and certainly the largest, is the post office, whose assets stand at ¥250 trillion, excluding the postal life insurance system's ¥123 trillion. Thus, excess savings have depressed yields and interest rates.

These excess savings, plus the social-security contributions gathered through payroll taxes, feed the Fiscal Investment and Loan Programme, the FILP. Through this programme, the Ministry of Finance lends money at low subsidised rates to a variety of institutions and projects, and this in turn encourages them to “over invest”. In the days of high growth the lending went mostly to industrial borrowers and the system's shortcomings were not so obvious. Nowadays, though, the biggest borrower is the Housing Loan Corporation, which provides low-cost mortgages. All told, the government has been providing over ¥5 trillion a year to keep the Housing Loan Corporation and other “special corporations” afloat.

There is a vicious circle here – construction has had too much funding at too low a rate for too long. The construction industry has over-expanded and is weighed down by debts. It needs to be smaller and more efficient and more responsive to market forces and demand. To reach that point would mean firms going bankrupt and jobs being lost, a lot of jobs. Because the banks are over-exposed to the construction industry, widespread failures in the construction industry would bankrupt some of the banks. This would be likely to cause panic in the financial system. There is no political will in Japan to start wielding the hatchet .....



*Interpretation: As the Nikkei has trended lower so have construction starts. Consumer confidence has shown stability over the last decade*

### What is to be done ?

Here some of the differences between the US thrifts and loans crisis and the Japanese situation become clearer. The thrifts had lent too much to householders wanting to buy houses; Japanese banks and other governmental institutions have largely lent too much to the construction industry. When Refcorp took over the thrifts' balance sheets, it was the shareholders and depositors of the thrifts who suffered, but by and large few jobs were lost. If a Japanese Refcorp were to take over the banks and set about getting their lending bank into shape, it would bring about the bankruptcy of a number of construction firms and related small businesses, with considerable job losses. But could a Japanese Refcorp skillfully use timing in sterilizing the bad loans, allowing a modernized and streamlined banking system to move forward, while minimising job losses or spreading them over sufficient length of time to allow for many to find other employment? Or has the situation already got so bad that this could not be achieved? Japanese companies have always shown considerable reluctance to trim workforces, since this means breaking obligations under the "life time" employment system, but in spite of this unemployment has risen to historical highs in Japan over the last few years.

But failing to force the change on the banks will simply prolong the current misery, and possibly lead to the build up of less democratic and more extreme measures to resolve the difficulty.

### Can the government bring about bank reforms that will work?

Government intervention is tricky, and can often make things worse. It is, on balance, better to permit a well functioning capital market to operate, which penalizes the losers, but rewards the winners. Resources get channelled into areas where the prospective

returns are highest, and this will pull the rest of the economy along behind it. Yet governments hate accepting that this is so and usually will do almost anything to prevent big businesses going bankrupt – this is particularly true in Japan.

The Japanese recession through the 1990s has not brought about a sufficient shaking out of dead wood, or a reduction in poor business practices. Too many banks and businesses struggle under the dead weight of debt and appear to think that the authorities will one day whisk away both the debt and the responsibility for dealing with it. But the message from the government is the very opposite – that is, if the government has the will to act as it speaks!

By next April the government has promised to lift its guarantee on ordinary deposits of over ¥10m. The trouble is that it is the weaker regional banks and credit unions who are rapidly losing deposits as the deadline draws near. This could cause them to cut back lending, much to the consternation of politicians who fear that this could spark a wave of corporate bankruptcies in their constituencies. In other words, just when there is a serious prospect of trying to make the capital market more efficient, other groups rush in to maintain the status quo.

On July 22nd Junichiro Koizumi, the prime minister, controversially declared that the reform could not be further delayed. Growing dissension among his LDP party had helped to stall bank reform. Not to be outdone, Mr Koizumi decided to re-allocate ministerial responsibilities. In order to continue the reform programme control over bank reform has now gone to the Economics Minister, Heizo Takenaka, who wants to tackle the current stalemate by injecting some sense into the way the banks are run. Along the way he wants to finally sort out the problems of banks' balance sheets and bad loans. He has said that no bank in Japan is "too big to fail".

This has un-nerved the market, hitting investment and consumption. It has created a classic "chicken and egg" problem. Belief in reform will only come when it really looks as though the commitment exists to tackle and overcome vested interests. The commitment to take on the vested interests only comes if people think it will work.. With 10 years of failed initiatives, there is some scepticism about the likely success of the latest initiatives.

***The lesson for the rest of us is to watch events in Japan very closely. What is happening there could very easily happen in the US, and from there to Europe. The recent cut in the Fed Rate now means that the US has "Japanese" style interest rates. It also means that the Fed has very little ammunition left with which to stimulate the US economy through monetary means. Indeed, there is a risk that high liquidity and low yields could push property prices even higher, and so recreate the spectacular bubble that went on to wreck the Japanese economy.***

*For investors, the lessons are even starker. Bonds, bonds, bonds. During the 1930's, bonds beat equities for a whole decade. You've been warned !!*